

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:BRK:TL-N-6887-98  
AJMandell

date: JAN - 5 1999

to: District Director, Brooklyn District  
Chief, Examination Division  
Attn: Jack Israel

from: District Counsel, Brooklyn

subject: [REDACTED]

THIS DOCUMENT MAY INCLUDE CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATE PROCESS PRIVILEGES, AND MAY ALSO HAVE BEEN PREPARED IN ANTICIPATION OF LITIGATION. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT IN RELATION TO THE MATTER OF THE CASE DISCUSSED HEREIN. THIS DOCUMENT IS ALSO TAX INFORMATION OF THE INSTANT TAXPAYER WHICH IS SUBJECT TO I.R.C. § 6103.

Reference is made to the memorandum supplied in response to your request to determine whether [REDACTED] could properly deduct a \$ [REDACTED] civil settlement payment pursuant to I.R.C. §162.

We stated in the memorandum that it was being referred to the National Office for review, that the review might result in modifications to the advice rendered therein, and that we would inform you of the results of the review.

The memorandum was reviewed by the subject matter specialists in the National Office. They notified us that they concur with our conclusion and analysis, but requested that we supplement the memorandum by adding a more detailed discussion of the statutory damage and penalty framework of the Federal False Claims Act.

Under the Federal False Claims Act, 31 U.S.C. §3729, there are three types of potential liabilities: (1) fines of \$5,000 to \$10,000, (2) treble (or sometimes double) damages, and (3) the Government's costs of a civil action. In this case, it appears that there was no cost of a civil action because none was filed. Consequently, none of the payment would be attributable to this element. Therefore, the taxpayer's payment could be attributable to the specific dollar fines or treble damages, which partially

11540

include a compensatory element.

It is not clear how many of the transactions in this case would subject the taxpayer to the specific dollar fines. It is possible that this amount could be determined through a count of the total number of billings made in connection with the contracts at issue. Depending on the number of false claim transactions, there could be a significant amount attributable to treble damages, especially because the taxpayer paid the Government the total amount of the contracts at issue (\$[REDACTED]). The settlement agreement provides information that indicates \$[REDACTED] is attributable to a "[REDACTED]" scheme that can be specifically identified as actual damages. As for the remainder of the payment, it is not clear how much is attributable to actual damages. While the taxpayer has the burden of proof, it is also important to consider that the FFCA does not provide for any penalties in excess of the specific dollar fines except those imposed under treble damages, which by definition also include a compensatory element. This means that the taxpayer will probably be entitled to some deduction for the actual damages, which are the purely compensatory amount of the treble damages. See Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). There does not appear to be evidence supporting the imposition of a penalty in excess of the amounts described in 31 U.S.C. §3729.

We note that in other FFCA cases, where there have been judgments, the Government received reimbursement for its cost of investigation through the penalty component of treble damages and the specific dollar fines. See United States v. Peters, 927 F. Supp. 363, 368-9 (D. Neb. 1996), *aff'd*, 110 F.3d 616 (8<sup>th</sup> Cir. 1997), *cert. denied*, 118 S. Ct. 162 (1997). The costs of investigation do not appear to be considered an element of actual damages under 31 U.S.C. §3729(a).

If you have any questions pertaining to this supplemental information, please contact the undersigned at (516) 688-1701.

DONALD SCHWARTZ  
District Counsel

By: 

ANDREW J. MANDELL  
Attorney

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:BRK:TL-N-6887-98

AJMandell

date: DEC 14 1998

to: District Director, Brooklyn  
Chief, Examination Division  
Attn: Jack Israel

from: District Counsel, Brooklyn

---

subject: [REDACTED]

U.T.L. 162.00-00; 162.21-01

THIS DOCUMENT MAY INCLUDE CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATE PROCESS PRIVILEGES, AND MAY ALSO HAVE BEEN PREPARED IN ANTICIPATION OF LITIGATION. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT IN RELATION TO THE MATTER OF THE CASE DISCUSSED HEREIN. THIS DOCUMENT IS ALSO TAX INFORMATION OF THE INSTANT TAXPAYER WHICH IS SUBJECT TO I.R.C. § 6103.

ISSUE

Whether [REDACTED]'s (hereinafter "[REDACTED]") \$[REDACTED] civil settlement payment constitutes a nondeductible fine or penalty pursuant to I.R.C. §162(f)?

FACTS

The facts, as we understand them, are as follows:

In what was dubbed "[REDACTED]", the U.S. Attorney, [REDACTED] and the Federal Bureau of Investigation conducted an extensive corruption inquiry into [REDACTED]'s operations. The investigation focused on the business and other relationships maintained by [REDACTED] with [REDACTED] and a number

---

[REDACTED] a close friend of [REDACTED], operated a [REDACTED] company and a number of other businesses in [REDACTED] until

of its employees, most notably former [REDACTED], [REDACTED]. "[REDACTED]" uncovered kickbacks and gratuities that [REDACTED] gave to [REDACTED] employees in exchange for the preferential treatment that [REDACTED] accorded his companies through bid rigging and favorable contract modifications. There were also a number of fraudulent transactions including a "[REDACTED]" scheme, which defrauded the government through false billing for goods that were never received (\$ [REDACTED] total). The upshot of this collusion was the elimination of competition for [REDACTED] contracts and the emergence of [REDACTED]'s companies as [REDACTED]'s dominant [REDACTED]. Inevitably, the costs of this corruption was borne by the government in the form of higher contract prices.

The misfeasance did not end there. [REDACTED] was also able to secure a lease agreement from [REDACTED] [REDACTED] [REDACTED] ( [REDACTED] ). In addition, there was evidence of improper involvement by [REDACTED] employees with a [REDACTED].

As a result of this investigation, a number of top level [REDACTED] employees were found guilty of defrauding the government. With the specter of legal proceedings on the horizon, [REDACTED] agreed to reimburse the government for all of the money that it paid for its business dealings with [REDACTED]-affiliated companies. This amount (\$ [REDACTED] ) and the sum that [REDACTED] paid the government for the costs of its investigation (\$ [REDACTED] ) represents the settlement amount (\$ [REDACTED] ) that [REDACTED] and the government agreed to on [REDACTED].<sup>2</sup>

The characterization of the \$ [REDACTED] settlement amount is imparted in paragraph seven of the Agreement:

[REDACTED]

his death in [REDACTED].

The settlement agreement also included a number of remedial measures that [REDACTED] agreed to implement to counteract the type of corruption covered by the government's investigation.

[REDACTED]

[REDACTED] deducted the entire \$ [REDACTED] settlement amount from its [REDACTED] taxable income on the basis that it was an ordinary and necessary business expense pursuant to I.R.C. §162. [REDACTED] contends that the settlement was restitution and therefore, a deductible compensatory damage award.

#### LEGAL ANALYSIS

I.R.C. §162(a) defines deductible business expenses as "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business ...". However, there is an exception to this rule. Section 162(f) disallows deductions for "any fine or similar penalty paid to a government for the violation of any law." Therefore, a business expense will not be deductible if it is characterized as a fine or penalty that is paid to a government.

However, there is no clear definition of a "fine or penalty." Treasury Regulation §1.162-21(a)(1) endeavors to dissipate some of this confusion by spelling out the parameters of a fine and penalty amount. Section 1.162-21(b)(1)(iii) is particularly apt: "For purposes of this section a fine or similar penalty includes an amount ... [p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal) ...". Consequently, settlement payments are not deductible business expenses if paid to settle liability for a fine or penalty even if the liability is undetermined. Courts interpreting this provision have held that sums paid in compromise of a liability, whether determined or not, take on the character of the underlying asserted obligation and are similarly nondeductible. Adolf Meller Company v. U.S., 600 F.2d 1360 (Ct. Cl. 1979) (holding that a compromise payment is to be treated as being of the same character as the underlying asserted obligation).

Nevertheless, the exemption of compensatory damage payments from §162(f) has dulled the ostensible clarity of this fine/penalty definition. Section 1.162-21(b)(2) exempts compensatory damage payments from the rubric of §162(f). Thus, much of the case law on §162(f) addresses the compensatory damage and fine/penalty dichotomy.

There is no hard and fast rule for deciphering the boundaries of this dichotomy. Nevertheless, there are some guiding principles courts utilize in resolving §162(f) litigation. A court must focus on the nature of the disputed payment. Middle Atlantic

Distributors, Inc. v. Commissioner,<sup>2</sup> 72 T.C. 1136 (1979); Talley Industries, Inc. and Consolidated Subsidiaries v. Commissioner, T.C. Memo 1994-608, rev'd and rem'd, 116 F.3d 382 (9<sup>th</sup> Cir. 1997). Was the payment intended, in whole or in part, as compensation for the government's losses, or as punishment for violating the law? In addressing the nature of a disputed settlement payment, courts look at the language of the agreement for evidence of the parties' intent. Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15 (1967) (holding that the language of the settlement offer supported the petitioners' contention that it represented liquidated contract damages suffered by the government and not a fine or penalty); Middle Atlantic Distributors, *supra* (holding that the characterization of the payment as damages by the parties must be given effect). Absent clear language of intent in the agreement, a court will consider the character of the underlying claim. With a settlement agreement, it is necessary to look to the statute ("origin of liability") that was allegedly violated to determine the claim's characterization. Uhlenbrock v. Commissioner, 67 T.C. 1384 (1987); Middle Atlantic Distributors. If the "origin of the liability" is purely compensatory or punitive, the court will determine the character of the claim accordingly. But, if the statute in issue has both punitive and compensatory objectives, the court will scrutinize the nature, amount and effect of the disputed payment, as well as evidence from settlement negotiations. Grossman, *supra*. In the end, the court has discretion in labeling the payment. Waldman v. Commissioner, 88 T.C. 1384 (1987).

Since the purpose of [REDACTED]'s settlement payment is unclear, it is necessary to resort to the aforementioned analysis. First, the [REDACTED] settlement agreement does not characterize the \$ [REDACTED] payment as either compensation for the [REDACTED] losses or as a civil penalty. It merely states that it was made in exchange for the government's agreement to surrender the civil claims it could have asserted against [REDACTED]. [REDACTED].

It appears that 31 U.S.C. §3729(a), commonly known as the Federal False Claims Act (hereinafter "FFCA"), is the settlement agreement's origin of liability. The FFCA subjects anyone who attempts to defraud the government by submitting false, fictitious or fraudulent statements, bills, receipts, etc. to a civil penalty of not less than \$5,000 and not exceeding \$10,000, and three times the amount of damages sustained by the government. The FFCA is a dual purpose statute because the remedies it provides have both compensatory and punitive characteristics. United States v. McLeod, 721 F.2d 282, 285 (9<sup>th</sup> Cir. 1983); Grossman & Sons, 48 T.C. 15 (1967). But, when an award under the FFCA bears no relation to the Government's actual losses, the part of the award exceeding actual losses may be considered penal. United States v. Halper,

490 U.S. 435, 452 (1989). As a result of the dual purpose of the  
FFCA, it is necessary to analyze the settlement agreement to  
dissect the language, intent, and effect of the payment.

The language of the settlement agreement sheds some light on the purpose of the payment. Pursuant to paragraph [REDACTED] of the settlement agreement, [REDACTED] agreed to pay the government \$[REDACTED]. However, the \$[REDACTED] payment is not intended to serve one purpose. Notably, paragraph [REDACTED], states that \$[REDACTED] of the \$[REDACTED] payment is intended "to reimburse the United States for all costs of the Government's investigation." Paragraph [REDACTED], characterizes the purpose underlying the remaining \$[REDACTED] of the settlement payment, but does not use the word "reimburse". Instead, it states that \$[REDACTED] is intended:

Thus, the agreement required [REDACTED] to reimburse the Government in [REDACTED] and then to pay the Government's civil claims in [REDACTED]. The plain language of this paragraph demonstrates that the amount described in [REDACTED] does not appear to be a reimbursement, but, rather, was payment of the government's civil claims. The Government's civil claims amounted to a forfeiture of all the money that [REDACTED] received from it to pay for the supply contracts it had with [REDACTED].

A survey of available background information on the settlement agreement reveals that little consideration was given to the actual losses that the government sustained as a result of [REDACTED]'s collusion with [REDACTED]. The few items of background information available reveal that the government was bent on punishing [REDACTED]. In a [REDACTED] article entitled "[REDACTED]"

The way the government endeavored to deter similar conduct was by exacting a high monetary settlement. As the article later points out, [REDACTED]'s payment covered [REDACTED]

Moreover, the \$ [REDACTED] settlement payment equaled the profits that [REDACTED] generally earns in one fiscal

quarter. [REDACTED]'s profits from the [REDACTED]-related contracts were not a factor. Furthermore, the government did not account for the value of the supplies it received from the [REDACTED]-related contracts. Namely, it did not assess the increased cost it incurred because of noncompetitive bidding. In fact, the only concrete loss figure deduced was the \$ [REDACTED] total for the [REDACTED] scheme. As a result, the settlement payment had little to do with returning the parties to the status quo.

Based upon the loss figures described in the settlement agreement, it appears that only \$ [REDACTED] of the \$ [REDACTED] that [REDACTED] paid the U.S. can be characterized as compensatory. This represents the \$ [REDACTED] designated as a reimbursement in [REDACTED] (cost of the government's investigation) and the \$ [REDACTED] in losses that the government incurred through the [REDACTED] scheme described on page [REDACTED] of the agreement. Accordingly, this portion should not be disallowed. The \$ [REDACTED] that remains from the settlement agreement, however, appears to be punitive in nature and if so, would be nondeductible pursuant to §162(f).

Based on the information provided, we would defend the disallowance of the \$ [REDACTED] amount remaining since the taxpayer has submitted no information showing what portion, if any, of that amount is compensatory. For example, if the taxpayer was able to detail the percentage that the government's cost increased because of the noncompetitive bidding, that percentage might be considered a loss that was compensated by some portion of the \$ [REDACTED].<sup>4</sup> However, [REDACTED], not the government, bears the burden of establishing entitlement to a deduction for amounts paid as compensation. Talley Industries Inc. v. Commissioner, 116 F.3d 382 (9<sup>th</sup> Cir. 1997), citing Norgaard v. Commissioner, 939 F.2d 874, 877 (9<sup>th</sup> Cir. 1991). The I.R.S. Restructuring and Reform Act of 1998 has not altered this burden because the examination began before the date of its enactment.<sup>5</sup>

---

<sup>3</sup>According to a [REDACTED] article dated [REDACTED] and entitled "[REDACTED]", \$ [REDACTED] represents the profits [REDACTED] generally earns in one fiscal quarter.

<sup>4</sup> There is no evidence in the file that during the course of its investigation the government ever attempted to calculate the losses that it sustained as a result of the preferential treatment that [REDACTED] accorded [REDACTED]'s companies.

<sup>5</sup> The IRS Restructuring and Reform Act of 1998, P.L. 105-206, 7/22/98 added I.R.C. §7491, which shifts the burden of proof in a court proceeding with respect to a factual issue that is



An examination of the effect of the settlement agreement appears to support the punitive intent inherent in its plain language. Did the settlement in this case have the effect of imposing a penalty on [REDACTED]? See Middle Atlantic Distributors. One punitive effect of the settlement discourse was the termination of the [REDACTED] executives who assisted [REDACTED] in acquiring the suspect government contracts. Another punitive effect was requiring [REDACTED] to implement provisions designed to enhance ethics-compliance and expose the company's decision-making processes to the eyes of federal watchdogs. Thus, not only did the government exact a severe monetary penalty, it also forced [REDACTED] to sacrifice a modicum of freedom and autonomy.

That this settlement has a punitive effect is also supported by the civil damage standards enunciated in United States v. Halper, 490 U.S. 435 (1989). In Halper, the Supreme Court established the "all the costs" limit and decided for double jeopardy purposes that a state-invoked civil remedy punishes to the extent the remedy exceeds "all the Government's costs." In that case, the Government sued Halper under the FFCA for submitting sixty-five false Medicare claims. However, because Halper was already jailed and fined for his acts of fraud, the court held that the statutory penalty authorized by the FFCA constituted a second punishment for double jeopardy purposes. It declared that the fixed penalty exceeded "all the Government's costs," and that civil damages recovered by a government are punishment when the damages bear "no rational relation to the goal of compensating the Government for its loss." 490 U.S. 449. Thereby, Halper established that punishment begins at the point where damages paid by the defendant exceed "all the costs" resulting from the defendant's illegal conduct.

Based upon the available facts, a court applying Halper's "all the costs" standard to [REDACTED]'s settlement agreement would deem the settlement payment punitive once the costs of the government's investigation and the losses it suffered from the [REDACTED] scheme are omitted. Consequently, it would find \$ [REDACTED] of the \$ [REDACTED] settlement payment to be punitive.

---

relevant to determining a taxpayer's liability if the taxpayer presents credible evidence with respect to that issue and cooperates with the Service and complies with substantiation and record-keeping requirements. This provision applies only to court proceedings arising in connection with examinations commencing after the date of enactment. In the present case, the examination began before July 22, 1998 and I.R.C. §7491 would not be applicable.

In the end, the court has discretion to label a payment as compensatory or remedial. However, in a situation where a settlement payment grossly exceeds the government's loss, it is unlikely that the court would go against the weight of the evidence by labeling a payment compensatory.

### CONCLUSION

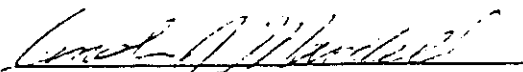
It is our position, based on the information currently available, that \$ [REDACTED] of [REDACTED]'s \$ [REDACTED] dollar settlement payment is an ordinary and necessary business expense and should be allowed. Based on the information provided to our office, we would defend the disallowance of the remaining amount. While we believe that there would be hazards of litigation associated with this disallowance if the taxpayer proffers additional information relating to the amount that the government was overcharged for the goods and services it received through the [REDACTED]-related contracts, we believe that this position can be sustained based on the facts and legal analysis presented above. Since the settlement amount vastly exceeded any loss that the government incurred from [REDACTED]'s involvement with [REDACTED]'s companies, it appears that the payment was intended to be a sanction. This proposition is supported by the settlement amount (\$ [REDACTED] exclusive of the government's litigation costs), which equals the amount the government expended on [REDACTED]-related contracts. Clearly, the government wanted to ensure that [REDACTED] never engaged in similar wrongdoing by requiring [REDACTED] to forfeit the amount it received for the [REDACTED]-related contracts without considering its actual loss. Such a severe penalty would likely deter similar conduct.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions, please call the undersigned at  
(516) 688-1701.

DONALD SCHWARTZ  
District Counsel

By:

A handwritten signature in cursive script, appearing to read "Andrew J. Mandell", written over a horizontal line.

ANDREW J. MANDELL  
Attorney